Mutual funds

A mutual fund is a company that makes investments for people who share common financial goals. This allows a group of investors to pool their assets in a diversified portfolio of stock, bond, options, commodities, or money market securities.

Mutual funds offer the investors the advantages of professional management and diversification. Diversification means that your investment risk is spread out. In addition, because your fund buys and sells larger blocks of securities at one time, its costs are lower than those typically paid by an individual.

Although limited-service mutual funds can be purchased directly, most are sold through brokers, banks, financial planners, or insurance agents and are known as full-service funds.

Some basic rules

Mutual funds – those bought through a bank – *are not guaranteed and are not insured.* As with any investment, mutual funds always carry a risk.

Depending on the type of investment objectives the fund has set, some types of funds may carry more risk than others. You should understand that a higher rate of return typically involves a greater risk of loss.

Past performance is not a reliable indicator of future performance. Among the factors to consider when making a mutual fund investment are the state of the stock and bond markets, interest rates, and the outlook for the economy

Mutual funds are not short-term investments. Frequent trading in mutual funds will result in sales commission eating up much of your principal.

How mutual funds work

An investment company pools the money of many people and invests it in stocks, bonds, or other securities that are selected by the fund manager to achieve the fund's objectives. These holdings of stock, bonds, or other securities are called a "portfolio."

The investment company earns money on the portfolio of securities and distributes the earnings to the investors as dividends. An investor buys shares of the fund, which represent an individual interest in the whole portfolio. The dividends paid out are in proportion to the number of fund shares the investor owns.

You can determine the value of your shares by looking in the financial pages of the larger newspapers. Find your fund’s name and then look under the column marked “NAV,” which refer to the Net Asset Value per share. NAV is the value of one share in a given fund. A fund’s NAV fluctuates daily as its holdings change in value.

Main types of mutual funds

Stock funds

Stock funds typically offer the highest returns but also involve more risk than money market or bond funds. Stock funds vary as well.

Some stock funds focus their portfolio purchases in a particular industry segment, such as technology or health care.

Bond funds

Bond funds may have higher risks than money market funds, but also seek to pay higher yields. There are many different types of bonds, so funds of this type can vary dramatically in both risks and rewards.

Money market funds

Compared to other mutual funds, money market funds have relatively low risks. Money market funds are limited by law to high quality, short-term investments. Still, as with any investment, losses are possible.

How funds can earn your money

You may get a return in your investment in any of the following ways:

A fund may earn dividends and interest on the securities in its portfolio;

The prices of the securities in the fund portfolio may increase. When these securities are sold, the fund has a capital gain. After deductions of any capital losses, most funds distribute these gains at year end; or

The fund retains the securities in its portfolio after the securities have increased in price and, therefore, the value of the fund shares (NAV) increases.

As an investor, you will have a capital gain when you sell your shares. Many funds offer the option of allowing dividends and distributions to be reinvested in the fund. These additional shares may be purchased with or without paying an additional sales load.

How to select a mutual fund

There are thousands of mutual funds to choose from, with a variety of investment objectives and levels of risk. If you do not have a clue where to start, obtain qualified, professional guidance from a broker.

It is also a good idea to talk with family members and friends who have successfully invested in various mutual funds. Find out what they did and did not like about the fund. The reference desk at your local library will refer you to directories of funds and reference books.

Whether you choose to go it alone or work with a professional, it is very important that you read and understand the mutual fund prospectus. When reading a mutual fund prospectus, pay close attention to the following areas:

The minimum dollar amount required to open an account;

The investment objective. Be certain that the fund's objective matches your own;

Look at the fund's performance. Although past performance is not an indicator of future performance, if the numbers in the prospectus do not please you, find another fund;

Be certain that the fund's level of risk matches your tolerance levels. Do not increase your level of risk tolerance in an attempt to gain a better return without fully understanding the risk you are taking;

Consider particular services or features of the fund, such as check writing or automatic reinvesting of dividends;

Review the fees you will be paying. Although fees are only one factor in the selection of a mutual fund, it is a factor you need to know about and understand before you invest.

Every fund is required to provide a prospectus at the time of purchase, or no later than the date of confirmation of your initial purchase. You can call or write the fund directly or ask your broker for a copy of the prospectus.

Terms to understand before you invest

Open-end vs. Closed-end mutual funds

If you purchase an “open-end” mutual fund, you will be able to cash in all or part of your shares at any time and receive the current value of your shares, which may be more or less than you originally invested. The “open-end” mutual fund provides liquidity if you need access to your money quickly. Purchasers of “closed-end” funds, however, can cash their shares only by finding another buyer through such sources as a stock exchange.

Load vs. No-load mutual funds

A ”load” refers to the sales charge paid by an investor who purchases a mutual fund. No-load funds, which are sold directly to the public, do not charge a sales load because you make your selection of funds without the assistance or advice of a broker.

When a mutual fund charges a sales load, you are usually paying a commission to the person who sold you the fund shares, as well as for the broker’s services and advice. If you are not familiar with this type of investment, the professional services and advice for which you pay a “load” may be worth the cost.

Front-end load vs. Back-end load

When you purchase shares in a mutual fund and pay a sales charge at that time, you are paying a front-end load. This type of charge reduces the amount of money you are investing in the fund.

For example, if you are investing $5,000 in a mutual fund with a 7 percent front-load, $350 will go to pay the sales charges and $4,650 will be invested in the fund. A back-end or deferred load is a sales charge you pay when you sell your shares. It usually is highest in the first year of your investment and gradually diminishes the longer you own the shares.

For more information:

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